No. 92-1941

In the Supreme Court of the United States

OCTOBER TERM, 1993

UNITED STATES OF AMERICA, PETITIONER

v.

JERRY W. CARLTON

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether curative legislation proposed in January 1987 and enacted in December 1987 retroactively to avert the potential abuse of an estate tax provision enacted in October 1986 violates due process when applied to a transaction entered into by an estate in December 1986.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-36a) is reported at 972 F.2d 1051. The opinion of the district court (Pet. App. 38a-42a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 10, 1992. A petition for rehearing with suggestion for rehearing *en banc* was denied on March 9, 1993 (Pet. App. 37a). The petition for a writ of certiorari was filed on June 7, 1993, and was granted on October 4, 1993. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Section 2057 of the Internal Revenue Code of 1986, as originally enacted, and as amended by Section 10411 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-432 to 1330-433, are set forth at Pet. App. 43a-46a.

STATEMENT

1. This case concerns the estate tax liability of the estate of Willametta K. Day, who died on September 29, 1985. The estate tax return for her estate was initially due on June 29, 1986.[1] Respondent (the executor of Ms. Day's will) sought and obtained a six-month extension for the filing of the return.[2] The return was therefore due on December 29, 1986 (Pet. App. 4a).

During the period of this six-month filing extension, Congress enacted the major revisions to the Internal Revenue Code contained in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Section 1172 of that Act added a new estate tax provision applicable to estates that filed timely returns after the date of the Act, October 22, 1986. See 100 Stat. 2513-2515. The new estate tax provision was codified as Section 2057 of the Internal Revenue Code of 1986, 26 U.S.C. 2057 (Supp. IV 1986).[3] It established a deduction for estate tax purposes of one-half of the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan" (26 U.S.C. 2057(a), (b) (Supp. IV 1986)).[4] To qualify for the new estate tax deduction under Section 2057, the sale of securities had to be made by the executor "before the date on which the [estate tax] return * * * is required to be filed (including any extensions)." 26 U.S.C. 2057(c)(1) (Supp. IV 1986).

2. Respondent sought to take advantage of this new provision in the following manner: (i) on December 10, 1986, more than a year after decedent's death and less than three weeks before filing the delayed estate tax return, respondent used estate funds to purchase 1,500,000 shares of the stock of MCI Communications Corporation (MCI) for $11,206,000 (representing an average price of $7.47 per share);[5] (ii) two days later, on December 12, 1986, respondent sold the MCI stock to the MCI Employee Stock Ownership Plan for $10,575,000 (representing an average price of $7.05 per share); and (iii) based on these transactions, respondent claimed a deduction under Section 2057 of one-half of the proceeds of the sale of stock to the MCI plan (or $5,287,000) on the estate tax return which he filed on December 29, 1986. The result of the claimed deduction was to reduce the reported estate tax obligation by $2,501,161 (Pet. App.

[1] Under Section 6075(a) of the Internal Revenue Code, the estate tax return is to be filed within nine months of the decedent's death. 26 U.S.C. 6075(a).

[2] The Secretary may allow extensions of time for the filing of any return. But "no such extension shall be for more than 6 months." 26 U.S.C. 6081(a).

[3] Section 2057 was repealed for the estates of persons dying after December 19, 1989. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2353.

[4] The term "employer securities" is defined in Section 2057 by reference to Section 409(*l*) of the Code, 26 U.S.C. 409(*l*) (Supp. IV 1986). In general, the term means common stock issued by the employer that is readily tradeable on an established securities market. See 26 U.S.C. 2057(e) (Supp. IV 1986).

[5] In December 1986, MCI was a publicly traded stock listed on the NASDAQ exchange. Its daily trading volume during this period was several million shares. See, *e.g.*, Wall St. J., Dec. 5, 1986, at 56; *id.*, Dec. 3, 1986, at 54; *id.*, Dec. 2, 1986, at 64.

4a-5a, 7a).[6]

3. On January 5, 1987, the Internal Revenue Service announced that it was seeking curative legislation to clarify that the deduction under Section 2057 was available only to estates of decedents who owned the securities in question *prior* to death. Notice 87-13, 1987-1 C.B. 432, 442. A bill to enact this proposed amendment to Section 2057 was introduced in both chambers of Congress on February 26, 1987. 133 Cong. Rec. 4145 (1987); 133 Cong. Rec. 4293 (1987).

When Section 2057 was originally enacted in 1986, Congress anticipated that the resulting benefit to taxpayers from this provision would be approximately $300 million. 133 Cong. Rec. 4145 (1987). As Representative

[6] By purchasing the 1,500,000 shares of MCI stock at a market price of approximately $7.47 per share on December 10, 1986, and selling the stock at $7.05 per share to the MCI ESOP on December 12, 1986, the estate lost $631,000 on the transaction (Pet. App. 4a-5a). But this loss was neither inevitable nor relevant to the claimed deduction.

The market price for MCI stock prevailing a few days earlier—on December 1 and December 2, 1986—was $6.50 per share. See Wall St. J., Dec. 2, 1986, at 64; *id.*, Dec. 3, 1986, at 54. If respondent had made his purchases on those dates at the market price of $6.50 per share, and had made the same sale of stock to the MCI plan on December 12, 1986, at the price of $7.05 per share which he in fact realized, the estate would have made a profit of $825,000 on the transaction. Even in that situation, however, the estate could still have claimed the same estate tax deduction of $5,287,500 under Section 2057, because the Section 2057 deduction is simply computed as one-half of the sale price. See 26 U.S.C. 2057(a) (Supp. IV 1986). Whether the estate made a profit or a loss on the sale is irrelevant to the deduction under Section 2057.

This case does not present the question of the proper tax treatment of the "loss" of $631,000 resulting from the purchase and sale of the MCI stock. Only the estate tax deduction (for one-half of the sale proceeds) under Section 2057 is at issue.

Rostenkowski, the Chairman of the House Ways and Means Committee, noted in introducing the 1987 amendment, however, it became clear shortly after passage of the 1986 Act that the projected revenue loss under Section 2057 could be as much as $7,000,000,000—more than 20 times the amount originally anticipated—because the statute did not explicitly limit the deduction to instances where the decedent owned the employee securities at the time of death (*ibid.*).[7] Senator Bentsen, the Chairman of the Senate Finance Committee, observed that "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987)). The provision had not been intended to permit a deduction for "essentially sham transactions" (*ibid.*).

The Committee Report on enactment of the 1987 amendment states that, "[w]hile Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction" (H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. II, at 1045

[7] Representative Rostenkowski noted that the 1987 amendment to Section 2057 effected the "congressional intent in enacting the [original] provision." 133 Cong. Rec. 4145 (1987). The Staff of the Joint Committee on Taxation had reported, in connection with the original enactment of Section 2057, that the provision was designed to create an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Staff of the Joint Comm. on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 37 (Comm. Print 1985). See also 132 Cong. Rec. 14,507 (1986) (statement of Sen. Long).

(1987)). The Report concludes that "[t]he provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized" (*ibid.*). The Report explains that the modifications contained in the bill are designed "to bring the revenue loss in line with the original estimate and Congressional intent" (*ibid.*).

The curative amendment to Section 2057 was enacted on December 22, 1987. The amendment was made effective as if it had been contained in the statute as originally enacted in October 1986. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 1330-433. The statute as amended in 1987 provides that, to qualify for the estate tax deduction under Section 2057, the securities sold to the employee stock ownership plan must have been "directly owned" by the decedent "immediately before death" (Pub. L. No. 100-203, § 10411(a), 101 Stat. 1330-432; see also 26 U.S.C. 2057 note (Supp. V 1987)).[8]

4. The Internal Revenue Service disallowed the claimed deduction for the sale of MCI stock on Ms. Day's estate tax return because the stock had been purchased after Ms. Day's death and was not owned by her "immediately before death." Respondent paid the resulting estate tax deficiency of $2,501,161, plus interest, and commenced this suit for refund in federal district court (Pet. App. 5a, 7a).

Respondent acknowledged that the estate did not qualify for the deduction under the amended provisions of Section 2057. Respondent contended, however, that the estate qualified for the deduction under the original provisions of Section 2057 and that the 1987 amendment to that statute could not constitutionally be applied retroactively. Respondent asserted that retroactive application of the 1987 amendment to the estate's 1986 transactions in MCI stock violated the Due Process Clause of the Fifth Amendment to the Constitution (Pet. App. 7a-8a).

[8] A complementary, prospectively applicable provision was enacted at the same time. See 26 U.S.C. 2057 (Supp. V 1987); Pub. L. No. 100-203, §§ 10411(b), 10412, 101 Stat. 1330-433 to 1330-436.

The district court rejected respondent's due process claim (Pet. App. 39a-41a). The court emphasized that "the Supreme Court has expressed doubt that foreseeability of retroactive legislation is even a 'relevant consideration' in Due Process Clause analysis" (Pet. App. 40a (quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. 717, 731-732 (1984)). Even assuming the relevance of foreseeability of the change, the court noted that "changes in tax laws are 'by [their] very nature . . . reasonably foreseeable' " and "the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress' continual responsibility to carry out the necessary policies of taxation" (Pet. App. 40a (quoting *Estate of Ekins* v. *Commissioner*, 797 F.2d 481, 483, 484 (7th Cir. 1986)). The court concluded that, while a taxing statute that retroactively imposes a wholly new tax may be challenged under the Due Process Clause, a retroactive "amendment[ ] that bring[s] about certain changes in operation of the tax laws, rather than the creation of a wholly new tax," is not constitutionally defective (Pet. App. 41a (quoting *United States* v. *Hemme*, 476 U.S. 558, 568 (1986)). The court held that the effect of the 1987 amendment on the availability of the Section 2057 deduction was not "harsh and oppressive" and that "retroactive application of the amendments to § 2057 [therefore] does not violate due process" (Pet. App. 39a, 40a).

5. A divided panel of the court of appeals reversed (Pet. App. 1a-36a). The court acknowledged at the outset that "retroactivity alone will not condemn a congressional enactment" (*id.* at 10a). The court rejected, however, "the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a 'wholly new' tax" (*ibid.*). The court concluded that the relevant inquiry under the Due Process Clause is whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation" (*id.* at 9a (quoting *United States* v. *Hemme,* 476 U.S. at 568-569)). In determining whether retroactive application of the 1987 amendment was "harsh and oppressive," the court looked to (i) whether "the taxpayer ha[d] actual or constructive notice that the tax statute would be retroactively amended" (Pet. App. 17a), (ii) whether "the taxpayer rel[ied] to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*).

The court concluded that retroactive application of the 1987 amendment violated due process because each of these three criteria was met in this case. Respondent lacked actual or constructive notice that the statute would be amended retroactively because "no act of the executive or legislative branch would have given any forwarning of the 1987 amendment at the time the MCI ESOP transaction occurred" (Pet. App. 17a-18a).[9] The court reasoned that respondent had "detrimentally relied on section 2057 as [originally] enacted" (*id.* at 19a) because he had "engaged in a costly transaction for no other reason than the inducement provided by the new section 2057" (*ibid.*). Although denial of the Section 2057 deduction would not detrimentally affect the estate's tax liability—for the taxes owed would be no greater than "if the ESOP proceeds deduction had never been enacted in the first place" (*id.* at 22a)—the court asserted that this "fails to account for the actual loss suffered by the estate" (*ibid.*):

> It was too late for [respondent] to undo his sale to the MCI ESOP. The $631,000 [loss on respondent's purchase and sale of MCI stock] was gone forever, irretrievable. [Pet. App. 19a.]

The court reasoned that this $631,000 loss represented the type of "detrimental reliance" that made retroactive application of the 1987 amendment unconstitutional (*ibid.*).

Finally, the court concluded that "the estate's reliance on the plain language of section 2057 was reasonable in light of the lack of any indication that an amendment was in the offing and in the context of the large tax incentives Congress has given to ESOPs" (Pet. App. 23a). Due to what it termed the reasonable, detrimental reliance of the estate and the unforeseeability of the amendment, the court concluded that retroactive application of the 1987 amendment to Section 2057, "as applied here, * * * is 'so harsh and oppressive as to transgress the constitutional limitation' " (Pet. App. 24a).

Judge Norris dissented (Pet. App. 25a-36a). He pointed out that deductions are purely a matter of legislative grace and that Congress has full power to revoke such benefits retroactively (*id.* at 30a (citing *Miller* v. *Com-*

[9] The amendments to Section 2057 were proposed to Congress in January 1987 and were enacted in December 1987. The court of appeals stated that "[w]e do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. * * * During this time period, the taxpayer is on notice that a change in law is forthcoming." Pet. App. 24a.

missioner, 115 F.2d 479, 480 (9th Cir. 1940), cert. denied, 312 U.S. 703 (1941)). He further noted that "[t]he Supreme Court and our sister circuits have made clear * * * that constructive notice to the taxpayer is usually implied for a change in the rate or basis of an existing tax" (Pet. App. 29a). He concluded that "[t]he majority, in reaching a different conclusion, creates a split among the circuits, as well as a conflict with our own, older precedent" (*id.* at 30a):

> I recognize that, if this case raised a question of statutory interpretation, neither the provision's legislative history nor its unfortunate economic effects could detract from the plain meaning of the text [of the original statute]. * * * But this case does not require us to interpret the 1986 statute, only to inquire whether Congress, in amending it, acted in an arbitrary and capricious manner, or "so harsh[ly] and oppressive[ly] as to transgress the constitutional limitation." [*Welch* v. *Henry*, 305 U.S. 134, 147 (1938)]. Because Congress's retroactive legislation limited the scope of a loophole that had been in effect just over one year, it did not transgress that boundary. [Pet. App. 35a-36a.]

SUMMARY OF ARGUMENT

The three-part substantive due process test adopted by the court of appeals departs from this Court's holdings and lacks any basis in the Constitution. The burden of sustaining retroactive legislation under the Due Process Clause is "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guar-*

anty Corp. v. *R.A. Gray & Co.*, 467 U.S. 717, 730 (1984). Retroactive tax legislation rationally drawn to achieve a legitimate legislative purpose does not violate the Due Process Clause even if the statute imposes a liability that "was not anticipated" or "upsets otherwise settled expectations" and "even though the effect of the legislation is to impose a new duty or liability based on past acts." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16 (1976). See also *Welch* v. *Henry*, 305 U.S. 134, 146-149 (1938).

Measured against this proper standard, the 1987 amendment to Section 2057 of the Internal Revenue Code does not offend due process. Retroactive application of the amendment to the date the statute was originally enacted represents a rational method of accomplishing a legitimate governmental purpose. The original phrasing of the statute made its benefits potentially available to estates whose transactions had no purpose other than tax avoidance. Congress had not intended to permit a deduction for such "essentially sham transactions" (133 Cong. Rec. 4294 (1987) (Sen. Bentsen)) and it was therefore necessary for Congress promptly and retroactively to correct the legislation that, on its face, permitted such patent abuse.

Legislation designed to cure errors in the drafting of tax legislation, and to close loopholes unintentionally created in the legislative process, is an especially fit subject for retroactive, as well as prospective, treatment. This Court has long recognized that Congress's "power to enact curative statutes" is "unquestionably valid." *Graham & Foster* v. *Goodcell*, 282 U.S. 409, 428 (1931).

ARGUMENT

I. THE 1987 AMENDMENT TO SECTION 2057 OF THE INTERNAL REVENUE CODE SATISFIES THE REQUIREMENTS OF DUE PROCESS BECAUSE IT CONSTITUTES A RATIONAL MEANS TO FURTHER A LEGITIMATE LEGISLATIVE PURPOSE

The decision of the court of appeals adopts and applies a novel and erroneous three-step substantive due process test for determining the constitutionality of retroactive tax legislation. The court's new test conflicts with the standards articulated under the Due Process Clause by this Court and by the other courts of appeals.

1. The "guaranty of due process" in the regulation of commercial matters "demands only that the law shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained." *Nebbia* v. *New York*, 291 U.S. 502, 525 (1934). As this Court stated in *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729:

> [T]he strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches.

The burden of sustaining retroactive legislation under the Due Process Clause is therefore "met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. Accord, *United States* v. *Sperry Corp.*, 493 U.S. 52, 64-65 (1989). Whether a "wiser or more practical" approach might be thought desirable "is not a question of constitutional dimension." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 19.[10]

Even when "[r]etroactive legislation presents problems of unfairness that are more serious than those

[10] Prior to *Nichols* v. *Coolidge*, 274 U.S. 531 (1927), "no federal revenue measure ha[d] ever been held invalid on the score of retroactivity." *Untermyer* v. *Anderson*, 276 U.S. 440, 449 (1928) (Brandeis, J., dissenting). In a series of cases in the late 1920's, however, the Court invalidated the retroactive application of certain taxes that the Court found to be "wholly unreasonable" (*Blodgett* v. *Holden*, 275 U.S. 142, 147 (1927) (opinion of McReynolds, J.)) and "whimsical and burdensome" (*Nichols* v. *Coolidge*, 274 U.S. at 542). In dissenting from the Court's holding in *Untermyer* that various retroactive features of the gift tax violated the Due Process Clause, Justice Holmes stated (276 U.S. at 446):

> I find it hard to state to myself articulately the ground for denying the power of Congress to lay the tax. We all know that we shall get a tax bill every year. * * * A tax may be levied for past privileges and protection as well as for those to come.

Justice Brandeis wrote a separate dissent in the *Untermyer* case, concluding that the Court had invalidated the retroactive features of the federal gift tax simply "because the action of the law-making body is, in its opinion, unreasonable." 276 U.S. at 447. Justice Brandeis stated that, "[f]or more than half a century, it has been settled that a law of Congress imposing a tax may be retroactive in its operation" and that in numerous instances an "additional tax [had been] imposed after the taxes for the year had been paid." *Id.* at 447, 448. Justice Brandeis noted, moreover, that the retroactive features of the challenged statute had "a special justification" because they were designed to prevent evasions of the tax. *Id.* at 450. As Justice Brandeis queried, in a comment also applicable to the present case, "Is Congress powerless to prevent such evasion by the vigilant and ingenious?" *Id.* at 450-451.

posed by prospective legislation" (*General Motors Corp.* v. *Romein,* 112 S.Ct. 1105, 1112 (1992)), "the test of due process" for the "retroactive aspects of [economic] legislation, as well as the prospective aspects," is whether they advance "a legitimate legislative purpose * * * by rational means." *Ibid.*, quoting *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730. While the Court has stated that "retrospective civil legislation may offend due process if it is 'particularly "harsh and oppressive" '" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 733, quoting *United States Trust Co.* v. *New Jersey*, 431 U.S. 1, 17 n.13 (1977), quoting *Welch* v. *Henry,* 305 U.S. at 147), this does not permit courts to reweigh the wisdom or fairness of the legislation (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729). Instead, the requirement that retroactive legislation not be "harsh and oppressive" is "met simply by showing that the retroactive application of the legislation" is rationally designed to accomplish a legitimate legislative purpose (*id.* at 730, 733). See *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Retroactive legislation rationally drawn to achieve a legitimate purpose does not violate the Due Process Clause even if the statute imposes a liability that "was not anticipated" or "upsets otherwise settled expectations" and "even though the effect of the legislation is to impose a new duty or liability based on past acts." *Ibid.* Accord, *Concrete Pipe & Products of California, Inc.* v. *Construction Laborers Pension Trust,* 113 S. Ct. 2264, 2287 (1993); *General Motors Corp.* v. *Romein,* 112 S. Ct. at 1112; *United States* v. *Sperry Corp.*, 493 U.S. at 64-65.

2. Legislation designed to cure errors in the drafting of tax legislation, and to close loopholes unintentionally

created in the legislative process, is an especially fit subject for retroactive, as well as prospective, treatment. It is a particular manifestation of the broad discretion vested in Congress to decide which groups of taxpayers are sufficiently similarly situated to warrant similar treatment. Congress unquestionably has a legitimate interest in designing revenue laws to fairly allocate to taxpayers the burdens and benefits of national fiscal policies and to prevent evasion of those laws "by the vigilant and ingenious" (see note 10, *supra*). If an unintended loophole is written into an enacted statute, and if Congress acts promptly to correct that error through curative legislation, it cannot be said that retroactive correction of the error lacks a rational relationship to the government's legitimate legislative objective. A curative, retroactive statute rationally designed to accomplish that legitimate purpose satisfies the requirements of due process. See *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 729, 733. See also *Graham & Foster* v. *Goodcell,* 282 U.S. 409, 428 (1931) (Congress's "power to enact curative statutes" is "unquestionably valid") (quoting *United States* v. *Heinszen & Co.*, 206 U.S. 370, 387 (1907) (upholding statute that ratified tariff duties collected eight years previously without authority)).[11]

[11] Even aside from the special justifications applicable to curative legislation, this Court has repeatedly upheld retroactive tax legislation. See, *e.g.*, *United States* v. *Hemme,* 476 U.S. 558, 566-567 (1986); *United States* v. *Darusmont,* 449 U.S. 292, 296-299 (1981); *Welch* v. *Henry,* 305 U.S. at 146-150; *United States* v. *Hudson,* 299 U.S. 498, 501 (1937); *Milliken* v. *United States,* 283 U.S. 15, 24 (1931); *Cooper* v. *United States,* 280 U.S. 409, 411 (1930); note 10, *supra.* Referring to the constitutional power to lay and collect taxes, the Court has observed that "[n]o more essential or important power has been conferred upon the Congress and

For this reason, "[c]ourts have consistently upheld the retroactive application of 'curative' legislation which corrects defects subsequently discovered in a statute and which restores what Congress had always believed the law to be" (*Long* v. *IRS*, 742 F.2d 1173, 1183 (9th Cir. 1984) (upholding retroactive amendment to the definition of "return information" under Section 6103 of the Code).[12] If Congress were unable retroactively to correct

the presumption that an Act of Congress is valid applies with added force and weight to a levy of public revenue" (*United States* v. *Jacobs*, 306 U.S. 363, 370 (1939)). Retroactivity is a common feature of tax legislation. "Congress almost without exception has given each such statute an effective date prior to the date of actual enactment." *United States* v. *Darusmont*, 449 U.S. at 296.

[12] Courts routinely have upheld such retroactive tax legislation. Among the many statutes considered and upheld are: (i) legislation including amounts withheld from employees' wages in the social security wage base (*New England Baptist Hospital* v. *United States*, 807 F.2d 280, 285 (1st Cir. 1986); *Canisius College* v. *United States*, 799 F.2d 18, 27 (2d Cir. 1986), cert. denied, 481 U.S. 1014 (1987); *Temple University* v. *United States*, 769 F.2d 126, 135 (3d Cir. 1985), cert. denied, 476 U.S. 1182 (1986)); (ii) legislation clarifying that the annual gift tax exclusion applied only to gifts valued at less than $3,000, and that the amount of the annual exclusion was not deductible from the value of gifts over that amount (*Reed* v. *United States*, 743 F.2d 481 (7th Cir. 1984), cert. denied, 471 U.S. 1135 (1985); *Estate of Ceppi* v. *Commissioner*, 698 F.2d 17, 21 (1st Cir.), cert. denied, 462 U.S. 1120 (1983)); (iii) a retroactive amendment clarifying that investment credit recapture is not to be taken into account in computing minimum tax liability (*Wiggins* v. *Commissioner*, 904 F.2d 311, 314 (5th Cir. 1990) ("We do not see how a new tax has been imposed by eliminating a loophole"); (iv) the retroactive elimination of the applicability of the annual gift tax exclusion to transfers of interests in life insurance (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 484-485; *Fein* v. *United States*, 730 F.2d 1211, 1213-1214 (8th Cir.), cert. denied, 469 U.S. 858 (1984)); and (v) an

loopholes unintentionally enacted in revenue laws, it would be left "powerless to carry out the yearly tinkering with the Code that is necessary to prevent losses of revenue and secure the national fiscal goal" (*Estate of Ekins* v. *Commissioner*, 797 F.2d at 485).

3. Measured by this proper standard, the 1987 amendment to Section 2057 does not offend due process. Retroactive application of the amendment to the date the statute was originally enacted (in October 1986) represents a rational method of accomplishing a legitimate governmental purpose.

Soon after the original enactment of Section 2057, Congress discovered that the statute contained an unintended loophole that threatened a staggering revenue loss. Congress had never contemplated application of the Section 2057 deduction to post-death purchases and sales of securities by estate administrators. Application of the statute in that manner vastly expanded the scope and effect of the deduction. See pages 4-5, *supra*. Absent any amendment, the statute would ostensibly permit estate tax deductions for transactions that had no purpose other than tax avoidance.[13] But Congress "did not

amendment to Section 6621 retroactively clarifying, in the wake of an adverse court decision, that the increased rate of interest applicable to tax-motivated transactions applies to sham transactions (*De Martino* v. *Commissioner*, 862 F.2d 400, 408 (2d Cir. 1988)).

[13] The original statute, on its face, could be read to allow any estate to obtain a deduction for its estate tax return (and even to eliminate its estate tax entirely) simply by purchasing employer securities on the open market and reselling them to an employer ESOP. Since the estate would claim a deduction for one-half of the proceeds of the sale from such a transaction (26 U.S.C. 2057 (Supp. IV 1986), any short-term market losses or transaction costs incurred would be matters of relatively little concern. A

intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" 133 Cong. Rec. 4294 (1987) (Sen. Bentsen)).[14] It would have been extraordinary for Congress to provide a deduction for such "essentially sham transactions" (*ibid.).* It was therefore necessary for Congress promptly and retroactively to correct the legislation that, on its face, permitted such patent abuse. As this Court has recognized, Congress may be "properly concerned" with the need for retroactivity to prevent abuse of its tax legislation. *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730.[15]

The means Congress employed to correct the potential abuse of Section 2057 were rationally related to this purpose. By limiting the availability of the Section 2057 deduction to estates of decedents who owned the securi-

transaction designed to accomplish nothing "beyond a tax deduction" (*Knetsch* v. *United States*, 364 U.S. 361, 366 (1960)) lacks economic substance.

[14] As the House Committee report states, "[t]he provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized," and "it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and Congressional intent" (H.R. Rep. No. 391, *supra*, at 1045).

[15] Congress is frequently required to make "retroactive revisions of the federal * * * revenue laws" (*Welch* v. *Henry*, 305 U.S. at 145). Such revisions are needed to correct prior drafting errors, to "impose[ ] taxes on subjects previously untaxed" and to "shift[ ] the burden of old taxes by changes in rates, exemptions and deductions" (*ibid.*). In preparing tax legislation, it is not always possible for Congress to foresee all possible applications of proposed statutory language. The possibility of drafting errors is far from negligible in a massive legislative undertaking such as the Tax Reform Act of 1986, a highly complex bill that made extensive revisions in the Internal Revenue Code.

ties at the time of death, the 1987 amendment rationally furthers the legislative purpose. Moreover, this amendment was made retroactive for "only that * * * period that Congress believed would be necessary to accomplish its purposes" (*Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 731). By making the curative legislation retroactive for the three-month period (October 1986 to January 1987) that preceded proposal of the 1987 amendment, the statute provides a uniform rule for all estates to which the deduction is available. It did not deny the benefits of the deduction to any estate that made a sale of securities that the decedent owned at death. The retroactive (and prospective, see note 8, *supra*) amendment merely forestalls abusive use of the statute by any estate to generate deductions for tax motivated, "essentially sham transactions" of the type in which respondent engaged.[16]

II. THE THREE-PART DUE PROCESS FORMULA APPLIED BY THE COURT OF APPEALS LACKS A FOUNDATION IN THE CONSTITUTION

In concluding that respondent is constitutionally entitled to different tax treatment from that accorded taxpayers engaging in similar transactions after Janu-

[16] In holding that the amendment to Section 2057 was unconstitutional as applied to respondent's purchase and sale of employer securities, the court of appeals lost sight of "the importance of reasonable opportunity for the legislative body, in the revision of the tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue." *Welch* v. *Henry*, 305 U.S. at 149. Curative legislation designed to staunch an unintended loss of revenue by "conform[ing] the statute to the original intent of Congress" (133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski)) represents a rational means of accomplishing the legitimate legislative purpose.

ary 1987, the decision of the court of appeals is virtually the only modern case to strike down a retroactive amendment to an existing tax on due process grounds. As Judge Norris noted in dissent, "[t]he majority's opinion substitutes a test much more sympathetic to the taxpayer than those that courts have used in the past" (Pet. App. at 31a).

The three-step due process test adopted by the court of appeals for retroactive tax legislation looks to (i) whether the taxpayer had "actual or constructive notice that the tax statute would be retroactively amended" (Pet. App. 17a), (ii) whether the taxpayer relied "to his detriment on the pre-amendment tax statute" (*ibid.*), and (iii) whether such reliance was "reasonable" (*ibid.*). For the reasons we have already set forth, this three-part test (which would import common-law concepts of promissory estoppel into the Due Process Clause) lacks any basis in the Constitution or the decisions of this Court.

1. Every taxpayer is deemed to be aware of, and thus have "constructive notice" of, the possibility of changes in the provisions of existing tax laws. Changes in the rates of tax, the amounts of exemptions and the availability of deductions and credits play a continuing role in the evolving process of defraying and apportioning the cost of government. "Nobody has a vested right in the rate of taxation." *Cohan* v. *Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930) (L. Hand, J.). The tax "system being already in operation," the taxpayer "must be prepared for such possibilities." *Ibid.* Congress is frequently called upon to make "retroactive revisions of the federal * * * revenue laws" and, in doing so, "impose[ ] taxes on subjects previously untaxed and shift[ ] the burden of old taxes by changes in rates, exemptions and deductions" (*Welch* v. *Henry*, 305 U.S. at 145). Every taxpayer

"should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation." *Milliken* v. *United States*, 283 U.S. at 23 (rejecting due process challenge to retroactive change in tax rate for certain gifts made prior to amendment). Because "no citizen enjoys immunity from that burden" (*Welch* v. *Henry*, 305 U.S. at 147), taxpayers can not "justly assert surprise or complain of arbitrary action" when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Id.* at 150.[17] See

[17] In *Welch* v. *Henry*, 305 U.S. at 147, the Court distinguished the *Nichols*, *Blodgett* and *Untermyer* decisions (see note 10, *supra*), which had held retroactive features of the first federal gift tax unconstitutional. As the Court stated in *United States* v. *Hemme*, 476 U.S. at 568, those decisions involved retroactive application of an entirely new type of tax; their "authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than the creation of a wholly new tax." See also *Milliken* v. *United States*, 283 U.S. at 23. As noted by Judge Norris in his dissent below, "[c]ases decided since *Welch* have upheld retroactive taxes on a variety of economic transactions, sharply limiting the scope of the *Lochner*-era cases" (Pet. App. 28a).

Notwithstanding this Court's admonition concerning the limited relevance of *Nichols*, *Blodgett* and *Untermyer* to cases involving "changes in operation of the tax laws," the court of appeals in the present case relied extensively on those decisions "to elucidate the factors we must consider in our determination" (Pet. App. 11a). By contrast, the other courts of appeals have consistently followed this Court's lead and limited those decisions to cases involving a "wholly new tax." See, *e.g.*, *Estate of Ekins* v. *Commissioner*, 797 F.2d 481, 484 (7th Cir. 1986); *Fein* v. *United States*, 730 F.2d 1211, 1213-1214 (8th Cir.) ("the modern trend of decisions has uniformly been to limit" *Untermyer* to the "narrow situation" there involved), cert. denied, 469 U.S. 858 (1984); *Estate of Ceppi* v. *Commissioner*, 698 F.2d 17, 21 (1st Cir.) (col-

also *United States* v. *Hemme,* 476 U.S. at 568; *United States* v. *Darusmont,* 449 U.S. at 298.

The many decisions of this Court that uphold retroactive "changes in operation of the tax laws" (*United States* v. *Hemme,* 476 U.S. at 568) do not dwell upon whether the taxpayer had "actual or constructive notice" (Pet. App. 17a) of the impending change. In *Milliken* v. *United States,* for example, the donor made gifts of stock in December 1916, when there was no gift tax but the estate tax applied to gifts made in contemplation of death. In 1918, Congress increased the estate tax rate on such gifts and applied that rate to gifts made prior to the enactment of the rate change. The donor died in 1920. His estate conceded that the 1916 gifts were includable in the taxable estate but contended that the

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lecting cases and concluding, in light of this Court's subsequent decisions, that "*Untermyer* at best remains good law only for the proposition that a wholly new gift tax cannot be applied retroactively"), cert. denied, 462 U.S. 1120 (1983); *Westwick* v. *Commissioner,* 636 F.2d 291, 292 (10th Cir. 1980) (limiting *Untermyer* to "wholly new types of taxes"); *Buttke* v. *Commissioner,* 625 F.2d 202, 203 (8th Cir. 1980) (per curiam) (*Untermyer* bars "retroactive application of [a] wholly new tax"), cert. denied, 450 U.S. 982 (1981); *Shanahan* v. *United States,* 447 F.2d 1082, 1083 (10th Cir. 1971) ("the force of *Untermyer* has been vitiated by *Milliken* v. *United States*"); *First National Bank in Dallas* v. *United States,* 420 F.2d 725, 730 n.8 (Ct. Cl.) ("it is not entirely clear, in light of the above and the ever-increasing role of taxation in every area of activity, that the same result would obtain in these early cases [referring to *Nichols* v. *Coolidge, Blodgett* v. *Holden,* and *Untermyer* v. *Anderson*] were they before the court today"), cert. denied, 398 U.S. 950 (1970); *Sidney* v. *Commissioner,* 273 F.2d 928, 932 (2d Cir. 1960) (Friendly, J.) ("If *Untermyer* remains authority at all, it is so only for the particular situation of a wholly new type of tax"). See also Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation,* 73 Harv. L. Rev. 692 (1960); Ballard, *Retroactive Federal Taxation,* 48 Harv. L. Rev. 592 (1935).

rate of tax could be no higher than that prevailing at the time the gifts were made. The Court held that taxing the gifts at the higher rate in effect at decedent's death did not violate due process (283 U.S. at 23):

> Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well understood purpose he should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them.

Similarly, in *Welch* v. *Henry,* the taxpayer's income in 1933 consisted in large part of dividends paid by corporations doing a majority of their business in Wisconsin. At that time, such dividends were deductible in computing net taxable income for purposes of the Wisconsin income tax. In 1935, however, Wisconsin imposed a graduated tax on all dividends received in 1933 which, when received, had been deductible from gross income under the law then in force. The Court upheld the measure, noting that Congress frequently enacts income tax laws that "redistribute[ ] retroactively the tax burdens imposed by preexisting laws." 305 U.S. at 148. The Court emphasized "the importance of reasonable opportunity for the legislative body, in the revision of the tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue" and that "[w]ithout that opportunity accommodation of the legislative purpose to the need may be seriously obstructed if not defeated." 305 U.S. at 149. See also *United States* v. *Hemme,* 476 U.S. at 568 (re-

jecting the taxpayer's contention that retroactive "changes in the operation of the tax laws" are unconstitutional).

Contrary to the decision of the court of appeals in this case, preliminary public notice is not a constitutional prerequisite for retroactive legislation. Many changes in proposed legislation are made in House or Senate Committees or during debate. Federal statutes often emerge from Conference Committee bearing only slight resemblance to the versions approved by either the House or Senate. By holding that a taxpayer must be placed specifically on notice of impending tax legislation for that statute to apply retroactively, the court of appeals has ignored this Court's consistent holding that taxpayers cannot "justly assert surprise or complain of arbitrary action" when Congress retroactively adjusts prior tax legislation in light of experience "at the first opportunity after knowledge of the nature and amount of the income is available." *Welch* v. *Henry*, 305 U.S. at 150. Even when there is no prior notice of the legislation, the Court has concluded that retroactive legislation satisfies the "substantive" requirements of due process because it represents a rational means of accomplishing the legislature's legitimate purpose. *E.g., General Motors Corp.* v. *Romein*, 112 S.Ct. at 1112; *Pension Benefit Guaranty Corp.* v. *R.A. Gray & Co.*, 467 U.S. at 730, 733.

2. The court of appeals further erred in concluding that respondent's purported reliance on the original terms of Section 2057 was "reasonable" (Pet. App. 23a). A taxpayer cannot "reasonably" rely on the assumption that Congress will not retroactively cure its prior drafting errors. As this Court has held, retroactive amendments of tax legislation are not unreasonable merely

because they may upset "otherwise settled expectations." *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. at 16. Such retroactive legislation has often been enacted and often been upheld. *United States* v. *Darusmont*, 449 U.S. at 298 (quoting *Welch* v. *Henry*, 305 U.S. at 146-147).[18] A taxpayer therefore cannot "justly assert surprise" when, as here, Congress retroactively cures an error in prior legislation "at the first opportunity" (*Welch* v. *Henry*, 305 U.S. at 150).

"Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits." *Welch* v. *Henry*, 305 U.S. at 146. Since "[n]obody has a vested right in the rate of taxation" (*Cohan* v. *Commissioner*, 39 F.2d at 545) (L. Hand, J.), a taxpayer cannot "reasonably" assume that an error or flaw in the formulation of tax legislation will not be corrected. See *Graham & Foster* v. *Goodcell*, 282 U.S. at 428.

That conclusion is especially appropriate when, as here, the statute on which the taxpayer purportedly

[18] This issue has arisen in many contexts. For example, a taxpayer's election to take advantage of a special benefit does not deprive Congress of the power to modify or withdraw the benefits of that election that would otherwise accrue in future taxable years. See, *e.g.*, *Lawler* v. *Commissioner*, 78 F.2d 567 (9th Cir. 1935) (upholding a statute revoking the installment method of reporting gain at the death of a taxpayer, even in the case of taxpayers who had previously elected to use the method). Deductions, credits and other tax benefits afforded under the Internal Revenue Code are privileges that may be revoked by Congress, not vested rights. See, *e.g.*, *Shanahan* v. *United States*, 447 F.2d at 1083; *Estate of Papson* v. *Commissioner*, 81 T.C. 105, 110 (1983); *Rose* v. *Commissioner*, 55 T.C. 28 (1970).

relied "on its face offered a benefit that appeared 'too good to be true'" (Pet. App. 34a) (Norris, J., dissenting). The amendment that Congress enacted to Section 2057 can scarcely have constituted a surprise to any thoughtful reader of the initial legislation. It was originally contemplated by Congress that the deduction "would be utilized in a limited number of transactions with a relatively modest revenue loss" (H.R. Rep. No. 391, Pt. II, *supra,* at 1045). If, as respondent contends, the original phrasing of the statute would have permitted every executor in the United States to negate the estate tax liability by the simple act of purchasing and reselling corporate securities, the fiscal impact of the legislation would obviously have differed greatly from Congress's original expectation.

Moreover, interpreting Section 2057 to permit a tax deduction for respondent's purchase and immediate resale of securities would flatly conflict with the well-established principle that purely tax-motivated transactions are not to be recognized for tax purposes. See, *e.g., Knetsch* v. *United States,* 364 U.S. at 366; *Gregory* v. *Helvering,* 293 U.S. 465, 470 (1935). As Senator Bentsen stated on the Senate floor in introducing the amendment, Congress did not intend to make the Section 2057 deduction available for "essentially sham transactions" (133 Cong. Rec. 4294 (1987)) and "did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (*ibid.*). Against this background, the court of appeals plainly erred in stating that respondent "had little reason to think Congress had made a drafting error" (Pet. App. 21a).

It did not require the sophisticated executor of a large estate to recognize that "the statute on its face offered a

benefit that appeared 'too good to be true'" (Pet. App. 34a) (Norris, J., dissenting). In amending the statute to make clear that it is not designed to provide a tax windfall "for essentially sham transactions," Congress did no more than confirm the ordinary understanding of the proper limits of the legislation.[19]

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[19] In concluding that the Section 2057 deduction "was enacted to induce taxpayers to sell shares at a discounted price to an ESOP" (Pet. App. 19a), the court of appeals misconstrued the purpose of the legislation. Section 2057 was enacted as an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Staff of the Joint Comm. on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 37 (Comm. Print 1985); see also 132 Cong. Rec. 14,507 (1986) (statement of Sen. Long). Section 2057 was designed to encourage stockholders who had built their companies to sell *their* shares to ESOPs, thereby making available to ESOPs a pool of stock that otherwise might never have been made available—not merely to encourage ESOPs to buy more shares from the public, or to make those shares available at a discount. As Judge Norris aptly noted (Pet. App. 35a), "Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!"

For example, in this case respondent asserts that the estate sold the shares to the ESOP at a discount of "26 cents per share" (Br. in Opp. 3). That assertion is debatable since respondent acknowledges (*ibid.*) that the lowest market price for the stock on that day was only 7.5 cents per share above the price at which respondent sold the stock to the ESOP. But, even if the discount were assumed to have been 26 cents per share, that discount would represent a total savings of only $390,000 for the 1,500,000 shares purchased by the ESOP. By comparison, the claimed estate tax deduction under Section 2057—of 50% of the total sale price of $10,575,000—would produce a tax benefit for the estate of more than $2,500,000 (Pet. App. 7a). If the Treasury had simply sent the ESOP a check for $390,000, the United States would have been more than $2 million better off than by providing the estate a deduction for this purely tax-motivated transaction.

3. Finally, the court of appeals' concern over respondent's alleged "detrimental reliance" on the original version of Section 2057 lacks both a legal and a factual foundation. The court concluded that the estate had relied on the statute to its detriment by engaging in a purchase and sale of MCI stock that resulted in a loss to the estate of $631,000. See note 6, *supra*. But, whether the estate makes a profit or a loss on its purchase and sale of stock is legally irrelevant to the availability of the Section 2057 deduction: the deduction is calculated simply as one-half of the gross proceeds received from the sale. See 26 U.S.C. 2057(a) (Supp. IV 1986).

Moreover, in this case (as in almost any case involving publicly-traded stock), respondent could have made a profit as easily as a loss on the estate's transaction. While the court of appeals emphasized repeatedly that the "estate was out $631,000" on its transaction in MCI stock (Pet. App. 23a), if respondent had purchased the MCI stock only a few days earlier, the sale would have netted the estate a sizeable profit instead of a loss. See note 6, *supra*. In either situation, the amount of the claimed deduction under Section 2057 would be the same. See note 6, *supra*.[20]

The necessary implication of the court's rationale is that the constitutionality of the amending legislation turns on whether respondent timed his purchases of

[20] Moreover, but for the fact that respondent was granted an extension to December 1986 of the time to file the estate tax return, the return would have been due in June 1986, before Section 2057 was enacted. See page 2, *supra*. When enacted, Section 2057 was made applicable only to estates for which returns had not then been filed. See page 3, *supra*. The estate cannot be said to have suffered any detriment from the denial of a deduction for which, but for the grant of a discretionary extension, it would not have been eligible in the first place.

MCI stock well or poorly. There is no precedent for such wavering constitutional guidelines for the validity of retroactive legislation.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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